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SEC Declares the DAO was a Securities Offering

*July 25, 2017: The SEC released an investigative report concluding that the DAO’s token issuance ran afoul of U.S. federal securities laws.*

The DAO, which stands for Decentralized Autonomous Organization, was a project run by a German company named Slock.it. The vision of the project was to realize the notion of companies and organizations run entirely by software instead of people. As a step in this direction, they built a crowdfunding mechanism using smart contracts. This involved the community contributing Ether, the cryptocurrency and computational “gas” of the Ethereum network, in exchange for DAO tokens. With these tokens, the community would vote on which projects would be funded by the DAO and receive dividends on the success of these projects. The DAO ran from April 30, 2016 to May 28, 2016 and raised about 12 million Ether, which at the time totaled $150 million ($2.4 billion at Ether’s current valuation.) The crowdfund was cut short when a hacker exploited one of several bugs in the smart contract, draining one-third of the funds. To combat this massive hack, the Ethereum core developers and community majority agreed to hard-fork the blockchain, effectively rewriting the history of the transactions as if the hack had never happened.

Many projects have utilized a similar method to raise funds: deploy what effectively amounts to a programmatic vending machine which accepts one currency and returns another digital asset of varying attributes. However, with over $1 billion raised with this method in 2017 alone, many were waiting for the SEC to break the silence regarding their stance on the matter.

On July 25, the Commission released an investigative report detailing the circumstances of the DAO’s design and implementation, concluding that the DAO tokens were in fact securities. The SEC defines a security as an investment contract in which there is an “investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” The DAO meets these conditions.

In a press release, SEC Chairman Jay Clayton said:

“The SEC is studying the effects of distributed ledger and other innovative technologies and encourages market participants to engage with us. We seek to foster innovative and beneficial ways to raise capital, while ensuring – first and foremost – that investors and our markets are protected.”

The SEC does not plan to charge Slock.it and other developers of the DAO with infringement of securities laws.

The long-defunct project was a perfect candidate for an SEC investigation. With many projects within the space turning to initial coin offerings (ICOs)/token sales to raise funds, there is now a warning for US-based companies and/or sales involving US investors.

While this report does not identify every issued asset in the blockchain space as a security by default, it does say that these tokens “may” be securities depending on the exact circumstances of their issuance and design and that these crowdsales must meet regulatory compliance.

The report also addresses that exchanges must also comply with certain regulatory frameworks if any of the tokens available for trading on the exchanges are deemed securities.

As a splash of cold water within the blockchain space, this report is certain to discourage some of the cavalier business practices that have plagued the industry since its inception. Is this the beginning of more direct regulatory action on the part of the SEC? Will this affect the pace of innovation? How this will impact the industry is impossible to tell until it has had more time to play out, but crypto projects will need to give it due consideration moving forward to secure their endeavors.

SOURCES:

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